

The American Law Institute Reporter's  
Study of Corporate Tax Integration:  
A Critique

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DAVID B. CLEMENT

Many of our apparently insoluble current tax problems were born in the original sin of sloppy thinking about defining income at a time when it was the subject of only a minor tax. Unfortunately, as the tax became major, its original sins resisted baptism. . . . The double taxation of corporate dividends can certainly be attributed to sloppy thinking about the relation of corporations and their shareholders under the income tax.<sup>1</sup>

**I. Introduction.**

The United States has long followed the so-called classical system of corporate equity taxation. Earnings of the corporation are taxed once at the corporate level and after-tax earnings of the corporation are generally subject to a second shareholder level tax. The shareholder tax may be levied close in time to the corporate level tax as in a dividend distribution made from current earnings and profits. Alternatively, the corporation may retain its after-tax earnings for a extended period resulting in stock value appreciation. The shareholder level tax is thus deferred until such time as the shareholder realizes a capital gain on sale or exchange of the appreciated stock.

In 1981, Professor Alvin C. Warren, Jr.<sup>2</sup> declared in a Harvard Law Review article that "The time has come . . . for the development of a complete legislative proposal for integration of

<sup>1</sup>Brannon, *Tax Loopholes as Original Sin: Lessons from Tax History*, 31 Vill. L. Rev. 1763, 1766, 1780 (1986) (rejecting the view of many commentators that the structural problems with our tax system are the result of lading it at political gunpoint with an assortment of illogical special interest provisions).

<sup>2</sup>Professor, Harvard University Law School, Cambridge, Massachusetts.

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the individual and corporate income taxes. It would be regrettable if the American Law Institute . . . were not a full participant in the debate . . . ."<sup>3</sup> Twelve years later, despite substantial scholarly debate, discussion in non-legal mainstream periodicals<sup>4</sup>, and general acceptance of corporate integration as a good thing in the abstract, the United States is no closer to implementation of any integration system than it was in 1981.

On March 31, 1993, the American Law Institute released the 238-page final version of Reporter's Study of Corporate Tax Integration<sup>5</sup> in which Professor Warren (as Reporter) recommends adoption of a shareholder credit integration system. While Professor Warren bases his discussion of the defects of the classical system of corporate taxation and the various systems of integration in large part on his 1981 Harvard Law Review article, the remainder of the Reporter's Study is noteworthy for its concrete proposals and detailed examination of the issues that

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<sup>3</sup>Warren, *The Relation and Integration of Individual and Corporate Income Taxes*, 94 Harv. L. Rev. 719, 800 (1981).

<sup>4</sup>See, e.g., Norton, *Our Screwed-Up Tax Code*, Fortune Magazine, September 6, 1993, at 34, 40-44 (cover story bemoaning double taxation of corporate earnings and citing integration systems of Germany, Britain, France and Japan as creating a more hospitable business environment); Boskin, *A Better Way to Tackle the Deficit*, Fortune Magazine, September 6, 1993, at 46 (promoting integration as one way to increase investment, income, wealth and jobs); Warsh, *On Avoiding Stewed Frogs*, Boston Globe, March 12, 1989 at A1; Brookes, *Bad Tax Policy Boosts Debt*, Nation's Business, January, 1990 at 77(1).

<sup>5</sup>Warren, American Law Institute, Federal Income Tax Project, *Integration of the Individual and Corporate Income Taxes*, Reporter's Study of Corporate Tax Integration, Final Version (1993) (co-Reporter, Professor William D. Andrews, Harvard University Law School, Cambridge, Massachusetts) [hereinafter cited as ALI Reporter's Study].

would have to be addressed in designing a shareholder credit integration system.

This article is intended as a critical review of the ALI Reporter's Study. While I discuss each of the Study's proposals at least briefly, I have intentionally limited my review to the domestic aspects of Professor Warren's integration system. I have thus ignored international considerations except as they relate preliminarily to the choice of integration systems.

I conclude that the ALI Reporter's Study is an important addition to the extensive body of literature extant on the subject of corporate integration<sup>6</sup>. Professor Warren largely succeeds in achieving the stated objective of the ALI Reporter's Study: "[T]o develop proposals that provide as complete a response as possible to the defects of current law by converting the corporate tax into a withholding device."<sup>7</sup> However, while the Study's description of the mechanics of the shareholder credit integration system is technically top-notch, it fails to offer compelling proof that integration is necessary. Similarly, the Study inadequately explains its preference for the shareholder credit integration method. The Study also fails to adequately explain the reason integration has not been

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<sup>6</sup>See generally extensive bibliographies found in the ALI Reporter's Study, *supra* note 5, at 223-238; in U. S. Treasury Department, Report on Integration of the Individual and Corporate Tax Systems -- Taxing Business Income Once (1992) at 253-266 [hereinafter cited as Treasury Report]; and in the American Institute of Certified Public Accountants, Tax Division, Statement of Tax Policy 10: Integration of the Corporate and Shareholder Tax Systems at 97-99 (1993) [hereinafter cited as AICPA Report].

<sup>7</sup>ALI Reporters Study, *supra*, note 5, at 2.

implemented in the United States despite initiatives during every Administration in the last twenty years.<sup>8</sup> Lastly, the Study's undervaluation of the political dimension of the integration debate and its failure to adequately address second order effects significantly detracts from the deference the Study would otherwise receive. In short, the ALI Reporter's Study is noteworthy but is not a "complete legislative proposal" nor is it likely to spark abandonment of the classical system any time soon.

## II. "Do No Harm"

Professor Warren offers two reasons for undertaking the ALI Reporter's Study. First, he notes that the classical system has long been roundly criticized for distorting financial decision-making with many critics offering integration as a panacea for correcting all that ails the classical system. Second, he notes the recent movement of many industrialized nations toward integration and suggests that the U.S. could be placed at a

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<sup>8</sup>See, e.g., Treasury Department, Tax Reform For Fairness, Simplicity, and Economic Growth (November, 1984) (50% dividends paid deduction); Treasury Department, Blueprints for Basic Tax Reform (1977) (shareholder allocation method); Warren, *The Relation and Integration of Individual and Corporate Income Taxes*, 94 Harv. L. Rev. 719, 793 (1981) (Carter Treasury Dept developed an imputation integration proposal that was never released to the public but which was discussed at a Brookings Institution conference in 1977); H. Res. 5300 (House passed a 10% dividends paid deduction in legislation leading to enactment of TRA 1986; provision was dropped during joint conference); Treasury Report, *supra* note 6; Treasury Department, A Recommendation for Integration of the Individual and Corporate Tax Systems (December 1992), reprinted in Daily Tax Report (BNA), Dec. 14, 1992, at L-7 (dividend exclusion method) [hereinafter cited as Treasury Recommendation].

competitive disadvantage.<sup>9</sup> This conjunction of international trade concerns with the familiar economic arguments against the classical system makes U.S. integration more compelling than ever.<sup>10</sup>

While the defects of the classical system and the adoption of integrated tax systems by many of our trading partners are well-documented, it does not necessarily follow that integration is right for the United States. While many commentators have advocated integration to remedy the distortions of the classical system, the tide of opinion running against integration is arguably just as strong.<sup>11</sup> As to the international dimension, one must bear in mind that the case for integration is much stronger in most other industrialized nations because of their generally higher corporate and individual tax rates.<sup>12</sup> Legislators should decide to integrate only after an exhaustive assessment finds that integration on balance is right for the United States. Integrating our domestic tax system must be based on reasons more substantial than a desire for lemming-like conformity in the interest of simplifying tax treaty

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<sup>9</sup>Compare AICPA Report, *supra* note 6, at 11, n. 19 ("There appears to be no empirical evidence to support the conclusion that adoption of an integration system would in fact improve the United States' competitive position.").

<sup>10</sup>ALI Reporter's Study, *supra* note 5, at 1-2; accord Treasury Report, *supra* note 6, at ix.

<sup>11</sup>See *infra* text accompanying notes 137-167.

<sup>12</sup>Sheppard, *Good Times, Bad Times: Business Tax Developments In the Last 20 Years*, 57 Tax Notes 840, 841 (November 12, 1992).

negotiations. The ALI Reporter's Study fails to offer convincing proof that the disease is worse than the cure.

Simply noting that the classical system of taxation distorts financial decision-making does not *a fortiori* prove the need for integration since any tax levy is inherently distortionary as compared to a world free of such tax. Accepting the proffered distortions as true, integration can only be worthwhile if it can be shown (1) that integration will reduce or eliminate the distortions of the classical system; (2) that reduction or elimination of the distortions is best achieved by integration; and (3) that integration will not result in second-order effects even more deleterious than those sought to be removed from the classical system. While the ALI Reporter's Study capably shows that integration can reduce or eliminate many distortions of the classical system, it does not adequately address other remedies or second order effects of integration.

### **III. Distortions of the Classical System of Corporate Taxation**

The ALI Reporter's Study indicts the classical system of double taxation for placing a heavier burden on U.S. corporate equity investment as compared to other forms of business investment. It identifies four major distortions that the integration literature generally accepts as axiomatic and that I accept as true for purposes of this critique.

First, the heavier relative burden discourages individuals from investing in corporate equity.<sup>13</sup> The double taxation of corporate source income may result in a misallocation of resources toward the noncorporate business sector to the detriment of corporate sector investment.<sup>14</sup> This bias against corporate equity investment results in decreased investment in capital-intensive activities whose large start up costs can only be financed by use of corporate form.<sup>15</sup> The double tax on corporate source income has been linked with decreased national savings and thus may retard capital accumulation and economic growth.<sup>16</sup> The double tax bite also may discourage foreign investment in the United States and hamper our ability to strike tax treaties with the many countries with integrated tax systems.<sup>17</sup>

Second, the classical system encourages corporations to fund new projects using debt or retained earnings as opposed to new

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<sup>13</sup>ALI Reporter's Study, *supra* note 5, at 3, 22-25; see also Treasury Report, *supra* note 6, at 3-4; Break and Pechman, Federal Tax Reform: The Impossible Dream?, 91-92 (1975); AICPA Report, *supra* note 6, at 3.

<sup>14</sup>ALI Reporter's Study, *supra* note 5, at 42; see also Treasury Report, *supra* note 6, at 3-4 (total effective federal income tax rate on corporate equity is 48% compared to 28% for noncorporate investment).

<sup>15</sup>AICPA Report, *supra* note 6, at 15; Break and Pechman, *supra* note 13, at 95. Break and Pechman also suggest that there may be a misallocation of resources within the corporate sector since the crazy quilt of corporate tax preferences has resulted in wide variance in the effective rate of tax paid by corporations. They also note that corporations that historically pay out a high percentage of their earnings (e.g., utilities) are particularly burdened by the classical system.

<sup>16</sup>AICPA Report, *supra* note 6, at 15-16.

<sup>17</sup>Cheney, *Call for an Integrated Tax System*, 59 Tax Notes 1820, 1821 (June 28, 1993).

equity.<sup>18</sup> The tax bias toward debt financing stems from the corporate deduction for interest paid and may undermine the financial health of corporations and increase the risk of bankruptcy.<sup>19</sup> The tendency of corporate managers to rely on debt or retained earnings places an unconscious, artificial ceiling on the amount of corporate capital expenditures. This psychological barrier can discourage corporations from pursuing capital-intensive opportunities that absent tax considerations would provide the best return on capital and encourage them instead to pursue service sector projects with low financing requirements.

Third, the classical system may encourage corporations to retain rather than distribute earnings.<sup>20</sup> When the corporate tax rate is less than the applicable individual rate, retention of earnings enables shareholders to mitigate the double tax bite through three capital gain preference mechanisms. They can avoid immediate taxation at the shareholder level by retention of earnings within the corporation. Retained earnings will result in increased share prices with shareholder taxation deferred

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<sup>18</sup>ALI Reporter's Study, *supra* note 5, at 3, 25-28; see also Treasury Report, *supra* note 6, at 4, 6 (total effective federal income tax rate on corporate debt is 20% versus 48% for corporate equity); Break and Pechman, *supra* note 13, at 95; AICPA Report, *supra* note 6, at 3. Compare Halperin, *Commentary: Will Integration Increase Efficiency?--The Old and New View of Dividend Policy*, Colloquium on Corporate Tax Integration, 47 Tax L. Rev. 645, 646 (1992) (reporting comment of Professor Shuldiner that "market limitations on the amount of debt that can be issued might make the debt/equity problem less serious than it appears").

<sup>19</sup>ALI Reporter's Study, *supra* note 5, at 42; see Treasury Report, *supra* note 6, at 4; AICPA Report, *supra* note 6, at 14.

<sup>20</sup>ALI Reporter's Study, *supra* note 5, at 3, 28-39; see Treasury Report, *supra* note 6, at vii, 3; Break and Pechman, *supra* note 13, at 91-92; AICPA Report, *supra* note 6, at 3.

until disposition of the stock (deferral effect). When the stock is sold, the shareholder may be taxed at a preferred capital gains rate (exclusion effect). If the shareholder holds the stock until death, the second tax bite is avoided forever by virtue of the IRC Section 1014 stepped-up basis provision (succession effect).<sup>21</sup> Retention of earnings at the corporate level is undesirable because the corporation may not be the best place for new investment by shareholders. If corporations paid out all their earnings and raised new capital through equity financing, corporate decision-making would be subjected to the test of the marketplace.<sup>22</sup>

Fourth, for a corporation that has decided to distribute its earnings to shareholders, the classical system encourages corporations to prefer nondividend distributions over dividend distributions.<sup>23</sup> Nondividend distributions become particularly attractive when the spread between individual ordinary income and capital gains rates is large. While the ability of corporations to obtain exchange treatment for their shareholders is subject to some restrictions<sup>24</sup>, those restrictions have not dampened corporate enthusiasm for nondividend distributions, particularly

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<sup>21</sup>McLure, *Integration of the Personal and Corporate Income Taxes: The Missing Element in Recent Tax Reform Proposals*, 98 Harv. L. Rev. 533, 537, 538 (1975).

<sup>22</sup>Sheppard, *Corporate Tax Integration: The Proper Way to Eliminate the Corporate Tax*, 27 Tax Notes 637, 638 (May 6, 1985).

<sup>23</sup>ALI Reporter's Study, *supra* note 5, at 3, 39-40.

<sup>24</sup>See IRC §305(b)(2), (c), applicable to distributions made after January 10, 1969.

share repurchases.<sup>25</sup> Corporate use of nondividend distributions as a tax-avoidance mechanism results in controversy between taxpayers and the Internal Revenue Service and enforcement is both expensive and administratively difficult.<sup>26</sup>

While the ALI Reporter's Study is on solid ground in its listing of the major economic distortions of the classical system, the Study then makes the startling assertion that "[e]ven if the existing system did not cause undesirable distortions in behavior, the distinctions created by current law would warrant legislative change because they have proven exceedingly difficult . . . to apply in practice."<sup>27</sup> While distinctions such as those between debt versus equity and redemption versus dividend certainly place a premium on tax planning and result in uncertainty and litigation<sup>28</sup>, I am aware of no other commentator who would argue that the high cost of administering the classical system alone is reason enough to pursue integration.

The ALI Reporter's Study states "[t]he tax-induced distortions of current law are undesirable to the extent they have deleterious economic effects (such as overreliance on debt

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<sup>25</sup>See generally Treasury Report, *supra* note 6, at vii, 4-5, 10-11 (25.5% of net interest paid by nonfinancial corporations in 1990 attributable to debt financing of share repurchases; "[s]hare repurchases increased substantially from 1970 to 1990, growing from \$1.2 billion (or 5.4 percent of dividends) to \$47.9 billion (or 34 percent of dividends) . . ."); Break and Pechman, *supra* note 13, at 91-92.

<sup>26</sup>AICPA Report, *supra* note 6, at 3, 17-18.

<sup>27</sup>ALI Reporter's Study, *supra* note 5, at 43.

<sup>28</sup>AICPA Report, *supra* note 6, at 3, 17-18.

finance by corporations) or create unadministrable legal distinctions (such as that between debt and equity). Integration would reduce or eliminate these undesirable effects."<sup>29</sup> While the ALI Reporter's Study has shown that the classical system is malfunctioning, that does not mean it is worth fixing, a fact to which any owner of high-tech gadgetry can attest.<sup>30</sup>

#### IV. An Ideal Corporate Tax Structure?

Implicit in the integrationists' argument for integration is the idea that the classical system departs from some ideal corporate tax structure. Put another way, if we had the luxury of constructing a tax system freed of the baggage of operating under the classical system for eighty years, what choices would we make? If we can agree on what such an ideal corporate tax structure would look like, then we can evaluate particular integration proposals to see how close they come to the ideal. The objectives of integration would then be keyed to eliminating distortions that move us away from the ideal.<sup>31</sup>

There is general agreement that the end to be achieved by any system of integration is to interrelate investor and

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<sup>29</sup>ALI Reporter's Study, *supra* note 5, at 3. For a more detailed overview of defects of classical system, see McLure, *Once is Enough: The Taxation of Corporate Equity Income* (1977), at 3-14 [hereinafter McLure, *Once is Enough*]; McLure, *supra* note 21, at 535-549.

<sup>30</sup>See *Getting Things Fixed -- Option: Don't Fix It*, Consumer Reports, Jan. 1994, at 34-36.

<sup>31</sup>See generally Yin, *Corporate Tax Integration and the Search for the Pragmatic Ideal*, Colloquium on Corporate Tax Integration, 47 Tax L. Rev. 431 (1992).

corporate taxes so that all corporate income is taxed once and only once.<sup>32</sup> The meaning of a "single level of tax" is less clear. Like many issues of tax policy, decisions made with respect to this foundational definition have broad implications for choice of an integration system and its structural characteristics. In the words of Professor Ginsburg, "where you start is everything."<sup>33</sup>

The 1992 Treasury Report on Integration of the Individual and Corporate Tax Systems [hereinafter Treasury Report] states that a single level of tax is achieved when all corporate income is taxed at the corporate level at a uniform rate.<sup>34</sup> This accords with the Treasury Report's focus on the economic effects of the classical system on business. Under this view, the fact that shareholders may receive a diminished return on their corporate investment as compared to a noncorporate investment is less significant than the fact that the cost of capital to corporations is increased.<sup>35</sup> For example, the Treasury Report's authors are not disturbed by the fact that exacting the toll at the corporate level means that tax-exempt entities are subject to

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<sup>32</sup>Treasury Report, *supra* note 6, at 12-13; ALI Reporter's Study, *supra* note 5, at 1; AICPA Report, *supra* note 6, at 18.

<sup>33</sup>Ginsburg, *Maintaining Subchapter S in an Integrated Tax World*, Colloquium on Corporate Tax Integration, 47 Tax L. Rev. 665, 677 (1992).

<sup>34</sup>Treasury Report, *supra* note 6, at 12-13.

<sup>35</sup>See, e.g., "Restructuring the U.S. Tax System for the 21st Century: an Option for Fundamental Reform," with Attachment 2, released by the Treasury Department Office of Tax Policy, December, 10, 1992, reprinted in BNA Daily Tax Report (December 11, 1992).

a heavier tax burden than they would be had they instead invested in noncorporate assets.<sup>36</sup> Indeed, the Treasury Report specifically recommends that the tax burden on tax-exempt entities with respect to corporate equity should not be reduced because of integration.<sup>37</sup>

The clear focus of the Treasury Report is to ensure that every dollar of corporate income is subject to taxation at a specified rate. For example, the Treasury Report does not recommend extending the benefit of corporate level tax preferences to shareholders as some corporate income would thereby escape all taxation.<sup>38</sup> Thus, "taxing business income once," the subtitle of the Treasury Report, means just that--all corporate income is taxed once without regard to the nature of the income or the tax classification of the recipient of corporate distributions.

Corporations are proper subjects for taxation in their own right under the Treasury approach. The problem is not taxing corporate earnings twice. The Treasury's plan provides dividend relief by allowing shareholders to exclude from gross income distributions out of corporate taxable income.<sup>39</sup> The Treasury's understanding of the meaning of "integration" is thus very

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<sup>36</sup>Treasury Report, *supra* note 6, at 15-16.

<sup>37</sup>*Id.*

<sup>38</sup>*Id.* at 15.

<sup>39</sup>Treasury Recommendation, *supra* note 8, at L-7; see also Yin, *supra* note 31, at 434-35.

narrow--to prevent a second shareholder level tax on dividends out of earnings that have already been taxed at the corporate level. The goal of such "integration" is to reduce the cost differential between debt and equity financing and to reduce the incentive for earnings retention within the corporate sector. While dividend relief "integration" would also incidentally reduce the bias against corporate equity investment, the broader issue of absolute equality between corporate and noncorporate investment opportunities is not a primary goal.

The Treasury Department admitted that its understanding of "integration" does not comport with the traditional formulation of commentators.<sup>40</sup> For example, most integrationists, including Professor Warren, reject the propriety of a corporate level tax on distributed income since individuals who engage in consumption ultimately bear the burden of all taxes.<sup>41</sup>

Several writers have suggested that an ideal corporate tax structure would be analogous to the existing partnership tax structure and thus designed to produce a single level of tax at the investor level.<sup>42</sup> The partnership (or flow-through) method replaces the corporate level income tax and instead allocates items of corporate income, loss, deduction and credit

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<sup>40</sup>Treasury Report, *supra* note 6, at 12-13.

<sup>41</sup>ALI Reporter's Study, *supra* note 5, at 45.

<sup>42</sup>See, e.g., McLure, *supra* note 21, at 549-50; Schler, *Taxing Corporate Income Once (or Hopefully Not at All): A Practitioner's Comparison of the Treasury and ALI Integration Models*, Colloquium on Corporate Integration, 47 Tax. L. Rev. 509, 521 (1992); Ginsburg, *supra* note 33, at 678; AICPA Report, *supra* note 6, at 19; Yin, *supra* note 31, at 433-34.

proportionately among its shareholders.<sup>43</sup> Commentators have described the flow-through method as administratively unworkable for corporate tax purposes but still a "conceptually pure" yardstick in that it assumes pass-through of all tax attributes to shareholders in proportion to their stock holdings.<sup>44</sup> Thus, "integration" under the partnership approach has a very broad objective: to ensure that the corporate source income of all shareholders -- high-bracket or low-bracket, taxable or tax-exempt, foreign or domestic -- is taxed in exactly the same fashion as their noncorporate source income.

The partnership method is thought to be conceptually pure in that it:

- furthers the goal of horizontal equity since corporate source income, whether retained or distributed, is taxed at the same rate as all other income of the shareholder.
- furthers the goal of vertical equity since corporate source income is taxed at the particular shareholder's marginal rate.
- would be neutral with respect to corporate financial decision-making since effective tax rates would not turn on whether the corporation distributed or retained its earnings.
- generally would not favor debt financing over equity financing since corporate payments would be subject to the same single tax at the shareholder level.

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<sup>43</sup>AICPA Report, *supra* note 6, at 43.

<sup>44</sup>McLure, *supra* note 21, at 549-50.

- would eliminate the bias against corporate investment since corporate source income would be taxed like any other capital income.<sup>45</sup>

The tide of opinion rejects the shareholder allocation or partnership method as administratively unworkable for several reasons:

- Corporations would have to keep records of which shareholders held its stock on any given date of the taxable year and would have to maintain complicated records to allocate properly each item of income, deduction or credit to its shareholders.<sup>46</sup>
- Shareholders would have to make adjustments to their stock basis in a manner akin to current partnership tax rules.<sup>47</sup>
- Layered corporations would pose problems since no corporation could properly allocate items to its shareholders until it had first received notice of its allocation of particular tax items from corporations in which it owns stock.<sup>48</sup>
- The increased use of stock options, stock warrants, preferred stock, and other queer capital interests has made the

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<sup>45</sup> McLure, *supra* note 21, at 549-50; AICPA Report, *supra* note 6, at 43-50; see Treasury Report, *supra* note 6, at 29.

<sup>46</sup> McLure, *supra* note 21, at 562; AICPA Report, *supra* note 6, at 44-45; see also Treasury Report, *supra* note 6, at 32-35.

<sup>47</sup> McLure, *supra* note 21, at 562; AICPA Report, *supra* note 6, at 45-46.

<sup>48</sup> McLure, *supra* note 21, at 562; AICPA Report, *supra* note 6, at 46; Treasury Report, *supra* note 6, at 35.

capital structure of corporations so complex that allocation of tax items among different capital interests is bewildering.<sup>49</sup>

- Shareholders might not have cash on hand to pay tax on their distributive share of retained corporate earnings.<sup>50</sup>

I agree with the commentators that the flow-through or partnership method is administratively infeasible. Still, for purposes of this critique, I accept the partnership method as a useful analytic tool.

#### V. Which System of Integration Is Best?

If the distortions of the classical system are undesirable, what is the best way to lessen those distortions? The integration literature contains many methods that could effectively reduce some or all of the distortions of the classical system. Whether one method is to be preferred largely depends upon the goals of "integration."

As discussed *supra* in Section IV., the precise scope of "integration" is disputed. In its broadest formulation, integration is designed to ensure absolute parity of tax treatment for corporate versus noncorporate source income. In its narrow formulation, the goal of integration is to ensure that

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<sup>49</sup>McLure, *supra* note 21, at 562; AICPA Report, *supra* note 6, at 48; Treasury Report, *supra* note 6, at 32-33.

<sup>50</sup>McLure, *supra* note 21, at 562; AICPA Report, *supra* note 6, at 48; see also Treasury Report, *supra* note 6, at 27-29 (Treasury's shareholder allocation prototype retains current corporate income tax as a withholding mechanism for payment of the shareholder level tax, as a measure to ensure compliance, and as a mechanism to deny the benefits of integration to tax-exempt shareholders).

corporate earnings that are taxed at the corporate level are not again taxed when distributed as dividends to shareholders. Which of these formulations (or a middle ground) is reflected in the ALI Reporter's Study?

While the ALI Reporter's Study adopts the broad formulation's prescription of a single *shareholder* level tax, it is philosophically closer to the narrow "integration" formulation. For example, in many respects, the ALI Reporter's Study is consistent with the Treasury Report's fixation on ensuring that no corporate income fall through the cracks. For example, the ALI Reporter's Study does not recommend that the benefit of corporate preferences be extended to shareholders nor that the tax burden on corporate source income of tax-exempt entities be reduced although the horizontal equity concept mandates those actions.<sup>51</sup> Thus, while a "single level of tax" could be interpreted to mean taxing all corporate income once at whatever rate applies to the particular distributee (zero percent for a tax-exempt shareholder), that is not the approach taken in the ALI Reporter's Study.<sup>52</sup>

The ALI Reporter's Study states that the "basic rationale" for integration is to eliminate the distortions of the classical system.<sup>53</sup> This reflects adoption of the narrow integration approach. While the ALI shareholder credit prototype does

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<sup>51</sup>*Id.* at 98, 163-64; see Yin, *supra* note 31, at 442.

<sup>52</sup>See Yin, *supra* note 31, at 442.

<sup>53</sup>ALI Reporter's Study, *supra* note 5, at 44.

contain certain structural features that more properly comport with a broad understanding of "integration", these digressions generally represent necessary departures to ensure the overall integrity of the integration model.

The ALI Reporter's Study does not explicitly list foundational precepts for design of its narrow integration system. However, we can distill and discern the key bedrock features of an integration system that Professor Warren would find acceptable:

1. The system must be administratively feasible.<sup>54</sup>
2. The system must be comport with the realization requirement of current law.<sup>55</sup>
3. The system must further the goal of vertical equity by exacting the ultimate single tax at the shareholder level.<sup>56</sup>
4. The system must tax corporate earnings, whether retained or distributed, once and only once.<sup>57</sup>

In the introduction to Part 2 of the ALI Reporter's Study, six methods for mitigating the distortions of the classical system are briefly reviewed. All are summarily rejected except

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<sup>54</sup>See ALI Reporter's Study, *supra* note 5, at 48-49 (rejecting partnership method because of complexity).

<sup>55</sup>See *Id.* at 49-50 (rejecting integration system that taxes shareholders on annual change in stock value).

<sup>56</sup>See ALI Reporter's Study, *supra* note 5, at 49 (rejecting dividend exclusion method because it applies the single, integrated tax on corporate earnings at the corporate level and not at the shareholder level).

<sup>57</sup>See *Id.* at 49 (rejecting a corporate level cash flow tax since it would effectively prevent current taxation of undistributed corporate earnings).

distribution related integration.<sup>58</sup> The Study fails to address perhaps the most obvious method for decreasing the tax burden on corporate source income: reduction or elimination of the corporate level tax.<sup>59</sup> Under Professor Warren's foundational precepts, it is clear he would find this method unacceptable since all shareholders would benefit equally from a tax cut and retained corporate earnings would escape current taxation.

Given the ALI Reporter's Study's adoption of the narrow integration formulation and its unstated foundational precepts, its recommendation of a distribution-related integration system comes as no surprise. What is unclear is why Professor Warren prefers the shareholder credit integration (or imputation) method over the dividend deduction method. After explaining the mechanics of the two methods and going to great lengths to prove that the tax results under the two methods is essentially equivalent, he then immediately turns his attention toward the structural aspects of an imputation system without an explanation for his preference.<sup>60</sup>

#### A. Shareholder Credit Integration

Under shareholder credit integration or imputation, the shareholder includes a grossed up amount in gross income equal to the amount of the dividend payment plus the associated corporate

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<sup>58</sup>*Id.* at 47-49.

<sup>59</sup>Feldstein and Frisch, *Corporate Tax Integration: A Quantitative Comparison of Alternatives* at 7 (1977).

<sup>60</sup>ALI Reporter's Study, *supra* note 5, at 50-58.

level tax withheld with respect to the dividend payment. The shareholder computes his federal income tax liability in the normal manner and is allowed a tax credit equal to the amount of the associated corporate level tax withheld with respect to the dividend payment. If the amount of the credit is greater than the tax liability of the particular shareholder, vertical equity would be adversely affected unless the shareholder is permitted to use the credit against his or her tax liability arising from other income or, if the shareholder has no other tax liability, the credit is refundable. The effect of the imputation method is that the corporate tax becomes simply a withholding tax on corporate source income distributed to individuals. Such distributed earnings are thus subject to a single tax at the shareholder's marginal bracket rate.<sup>61</sup>

While designing an integration system would be a simple exercise if every shareholder was an individual U.S. citizen, designing a system that ensures a single level of tax on corporate source income paid to tax-exempt, corporate, and foreign shareholders results in complexity. A key structural advantage of the imputation method is that the credit mechanism can be used to deny the benefits of integration to "all those troublesome folk."<sup>62</sup>

The advantages of shareholder credit integration include:

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<sup>61</sup>*Id.* at 50-52; see AICPA Report, *supra* note 6, at 54-59.

<sup>62</sup>ALI Reporter's Study, *supra* note 5, at 52. The troublesome folk appellation is from Ginsburg, *supra* note 33, at 677.

- It eliminates the double taxation problem with respect to dividend distributions so that from the shareholder's perspective the bias against corporate investment is reduced.<sup>63</sup>
- It furthers the goal of vertical equity by taxing distributed corporate earnings at the shareholder's marginal bracket.<sup>64</sup>
- In modified form, it can extend the benefits of integration to earnings retained by the corporation.<sup>65</sup>
- It reduces the tax incentive for retention of corporate earnings within the corporation.<sup>66</sup>
- It can flexibly address the issue of whether the benefit of corporate tax preferences is passed to shareholders.<sup>67</sup>
- It is easy to administer if a fixed-rate credit is used.<sup>68</sup>
- The credit mechanism allows discrimination against foreign and tax-exempt shareholders.<sup>69</sup>

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<sup>63</sup>Cheney, *supra* note 17, at 1822; AICPA Report, *supra* note 6, at 55, 59.

<sup>64</sup>Cheney, *supra* note 17, at 1822; AICPA Report, *supra* note 6, at 55, 59.

<sup>65</sup>ALI Reporter's Study, *supra* note 5, at 15, 126-27; AICPA Report, *supra* note 6, at 57.

<sup>66</sup>Cheney, *supra* note 17, at 1822; AICPA Report, *supra* note 6, at 55, 59.

<sup>67</sup>Cheney, *supra* note 17, at 1822; AICPA Report, *supra* note 6, at 57.

<sup>68</sup>Cheney, *supra* note 17, at 1822; AICPA Report, *supra* note 6, at 55, 59.

<sup>69</sup>Cheney, *supra* note 17, at 1822; AICPA Report, *supra* note 6, at 56-57.

- The credit mechanism ensures taxpayer compliance since the corporation pre-pays the shareholder's tax; shareholders must file returns to claim the benefit of the credit.<sup>70</sup>
- Because imputation is the system adopted by most countries that have integrated their corporate and individual tax levies, the U.S. can benefit from international experience.<sup>71</sup>
- The prevalence of imputation among industrialized nations simplifies negotiation of tax treaties.<sup>72</sup>

The disadvantages of shareholder credit integration include:

- As a distribution-related integration method, basic imputation only provides relief as to dividend distributions. This represents a departure from the partnership ideal since retained earnings are not currently taxed at the shareholder's tax rate. Under imputation, retained earnings are currently taxed at a specified corporate rate with ultimate correct taxation deferred until the shareholder receives a distribution of the earnings.
- If the shareholder realizes a capital gain on the sale of stock, a portion of the capital gain will likely be attributable to the retention of after-tax earnings by the corporation. Nevertheless, no credit is available to prevent the double

<sup>70</sup>Cheney, *supra* note 17, at 1822; AICPA Report, *supra* note 6, at 58-59; Sheppard, *supra* note 22, at 646.

<sup>71</sup>AICPA Report, *supra* note 6, at 56, 59.

<sup>72</sup>*Id.*; Treasury Report, *supra* note 6, at 93.

taxation of those earnings.<sup>73</sup> As discussed *infra* at Section VI.C., a constructive dividend and reinvestment option can mitigate but not completely correct this problem.

- It does not pass losses through to shareholders and thus departs from an ideal corporate tax structure (the partnership method).
- Despite the global equivalence of equity and debt financing, corporate managers may still prefer debt since they can perceive the immediate relief of a tax deduction.<sup>74</sup>
- Because the full benefits of integration under an imputation system are generally not extended to foreign shareholders or foreign income of U.S. corporations, imputation may encourage Balkanization of the international economy since residents are encouraged to invest in domestic corporations earning domestic income (i.e., corporations that can pass credits to their shareholders).<sup>75</sup>

#### B. The Dividend Deduction Method

Under the dividend deduction method, the corporation gets a deduction equal to amounts paid as dividends. The immediate effect of the deduction is to equalize the tax treatment of

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<sup>73</sup>Schler, *supra* note 42, at 520.

<sup>74</sup>McLure, *supra* note 21, at 556; AICPA Report, *supra* note 6, at 55.

<sup>75</sup>Tillinghast, *Corporate-Shareholder Integration as an Obstacle to the International Flow of Equity Capital: A Proposal*, 56 Tax Notes 1215 (August 31, 1992); Wrappe, *The Protectionist Potential of the Imputation Form of Corporate Integration*, 49 Tax Notes 727 (1990); see also AICPA Report, *supra* note 6, at 10, 13.

dividend and interest payments. Thus, the burden of the corporate income tax will fall only on retained earnings.<sup>76</sup>

The immediate result of this method is more cash in hands of the corporation allowing corporate managers to increase dividend amounts paid to shareholders should they so desire.<sup>77</sup> As the corporation has increased cash flow, some integrationists prefer the dividend deduction method since it provides additional opportunities for corporate capital accumulation. On the downside, this approach automatically extends the benefits of integration to tax-exempt and foreign shareholders.<sup>78</sup>

The dividend deduction method is theoretically simpler than imputation from the shareholder's perspective since integration is achieved through adjustments made at the corporate level.<sup>79</sup> This simplicity is illusory, however, because tax policy decision makers are unlikely to enact any integration system that applies the single, immutable tax at the shareholder level without some guarantee of taxpayer compliance. Accordingly, any likely

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<sup>76</sup>ALI Reporter's Study, *supra* note 5, at 52-53; McLure, *supra* note 21, at 554-55; Smith, *Tax Treatment of Dividends*, House Committee on Ways and Means, 3 Tax Revision Compendium 1543, 1544 (1959), excerpted in Sander and Westfall, *Readings in Federal Taxation* (1970); Bittker and Eustice, *Federal Income Taxation of Corporations and Shareholders* (5th Ed.), 1993 Cum. Supp. at ¶1.08.

<sup>77</sup>ALI Reporter's Study, *supra* note 5, at 52-53; Sheppard, *supra* note 22, at 644; USA: Corporate Finance - Would Cutting the Dividend Tax Really Help?, *Institutional Investor* (U.S. Edition) at 73 (August 30, 1990) (not clear that eliminating the double taxation of dividends would lead to increased payout levels as corporate managers might simply plow money back into the business).

<sup>78</sup>ALI Reporter's Study, *supra* note 5, at 52-53; Treasury Report, *supra* note 6, at 107.

<sup>79</sup>ALI Reporter's Study, *supra* note 5, at 53; Sheppard, *supra* note 22, at 644.

dividend deduction schematic would require the corporation to pay over to the fisc some portion of dividends paid to each shareholder as a withholding mechanism.

The advantages of the dividend deduction method include:

- It is easy to administer.<sup>80</sup>
- It furthers the goal of vertical equity by taxing distributed corporate earnings at the shareholder's marginal bracket.<sup>81</sup>
  - Because a corporation receives a deduction for dividends paid, this method eliminates corporate bias toward debt financing.<sup>82</sup>
  - As discussed above, it increases corporate after-tax cash flow and so corporate managers would be more likely to support integration under this method rather than the imputation method.<sup>83</sup>

The disadvantages of the dividend deduction method include:

- As a distribution-related integration method, it only provides relief as to dividend distributions. Retained earnings remain subject to the corporate tax. If the shareholder realizes a capital gain on the sale of stock, a portion of the capital gain will likely be attributable to the retention of after-tax

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<sup>80</sup>AICPA Report, *supra* note 6, at 51, 54; McLure, *supra* note 21, at 564.

<sup>81</sup>Cheney, *supra* note 17, at 1821-22; AICPA Report, *supra* note 6, at 50, 54.

<sup>82</sup>Smith, *supra* note 76 at 1544; McLure, *supra* note 21, at 554-55; Treasury Report, *supra* note 6, at 107.

<sup>83</sup>Sheppard, *supra* note 22, at 647.

earnings by the corporation and so double taxation is not completely eliminated.<sup>84</sup>

- It falls short of partnership-like integration in that losses of the corporation are not passed through to shareholders.
- It may result in a misallocation of resources by discriminating against corporations that cannot distribute their earnings for business reasons.<sup>85</sup>
- It extends the full benefits of integration to all shareholders including tax-exempt entities and foreigners. While the U.S. could ensure that distributions made to foreign shareholders are taxed fully by increasing withholding rates on dividends, such action would require the renegotiation of many existing treaties.<sup>86</sup>
- It is less flexible than the imputation system in passing through corporate tax preferences to shareholders.<sup>87</sup>
- Because it differs from the imputation systems used by most countries, it complicates negotiation of tax treaties.<sup>88</sup>

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<sup>84</sup>AICPA Report, *supra* note 6, at 52, 54.

<sup>85</sup>Smith, *supra* note 76, at 1545 ("If dividends are deductible, the corporate tax becomes a tax on retained earnings, and retained earnings are by far the most importance source of equity capital for industry in this country. What is intended as relief for dividends paid becomes a penalty on earnings retained. For those companies which have to retain all or virtually all of their earnings ... a corporate tax solely on retained earnings would surely be regarded as a penalty on growth.").

<sup>86</sup>ALI Reporter's Study, *supra* note 5, at 53; AICPA Report, *supra* note 6, at 51-52, 54; Sheppard, *supra* note 22, at 645.

<sup>87</sup>AICPA Report, *supra* note 6, at 52, 54.

<sup>88</sup>Cheney, *supra* note 17, at 1821-22; AICPA Report, *supra* note 6, at 51, 54.

- It lacks a structural compliance feature so that an auxiliary withholding mechanism would be required.

C. Warren's Preference for Shareholder Credit Integration  
*Is Unexplained But Justified*

While Professor Warren inadequately explains his preference for shareholder credit integration over the dividend deduction method, I believe his choice is sound. My examination of the pros and cons convinces me that on balance the imputation method is better able to address the toughest issues encountered in designing an integration system. In particular, the imputation method's flexibility in handling tax-preferred income, tax-exempt shareholders and foreign investors coupled with its compatibility with foreign integration systems makes it the best system.<sup>89</sup>

VI. The ALI Reporter's Study Integration Proposals

The ALI Reporter's Study contains twelve concrete proposals that would convert the corporate income tax into a withholding mechanism for an ultimate tax on corporate source income at the shareholder level.<sup>90</sup> Professor Warren's imputation model is technically first rate and clearly explained in a three step process. First, he explains the particular structural challenge,

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<sup>89</sup>See, AICPA Report, *supra* note 6, at 67 (recommending shareholder credit integration); McLure, *supra* note 21, at 581-82 (preferring shareholder credit integration over dividend deduction method). But see Treasury Report, *supra* note 6, at 15 (favoring dividend exclusion system over imputation).

<sup>90</sup>ALI Reporter's Study, *supra* note 5, at 13-20. To aid the reader and for ease of reference, the twelve proposals are reproduced as Appendix A to this paper.

methods of addressing the issue, and advantages and disadvantages of each method. Second, he makes a specific proposal. Finally, he provides detailed comments explaining his reasons for and the operation of his proposal.

Proposals 1-4 establish the basic structure for the recommended imputation model. Proposal 5 provides a mechanism for extending integration benefits to earnings retained by corporations. Proposals 6 and 7 provide rules to ensure that corporate source income does not escape the single, integrated tax by sale, death, redemption or liquidation. Proposals 8-10 provide recommendations for special shareholders: corporate, tax-exempt, and foreign. Proposal 11 provides a rule by which a U.S. corporation may avoid further taxation of foreign source income that another nation has already taxed. Proposal 12 provides rules to phase in integration over an unspecified period by adjusting various corporate financial accounts.

In the following sections, I point out noteworthy aspects of many but not all of the 12 proposals. Because I have intentionally limited this critique to the domestic aspects of the ALI proposal, I do not address Proposals 10 or 11 at all.

#### A. *Coverage of the ALI Imputation Model*

While the structure and operation of the ALI imputation model is generally clearly explained, the intended coverage of the integrated tax system is unclear. Does the ALI Reporter's Study envision that Subchapter S corporations will have continued

viability?<sup>91</sup> It does not say. If the sole function of the corporate tax is to serve as a withholding mechanism for an ultimate tax at the shareholder level, do we need a corporate level alternative minimum tax?<sup>92</sup> The ALI Reporter's Study does not take a position on the issue.<sup>93</sup>

*B. Basic Structure of the ALI Imputation Model*

Proposals 1 and 2 provide a correlative system by which a corporation will in effect prepay the income tax liability of its shareholders with respect to all dividend distributions.<sup>94</sup> For this purpose, whether the corporation has accumulated or current earnings and profits is irrelevant and, indeed, this is one area where the ALI imputation model would simplify tax administration by eliminating the earnings and profits concept.<sup>95</sup> Under Proposal 1, the cumulative amount of U.S. corporate income taxes paid by a corporation is tracked in a Taxes Paid Account (TPA). All dividends paid by the corporation will carry out an associated shareholder credit computed at the highest individual marginal tax bracket in the year of distribution and will reduce

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<sup>91</sup>See Ginsburg, *supra* note 33, at 665; McNulty, *Colloquium on Corporate Tax Integration, Commentary: Preserving the Virtues of Subchapter S in an Integrated World*, 47 Tax L. Rev. 681 (1992); Schenk, *Colloquium on Corporate Tax Integration, Commentary: Complete Integration in a Partial Integration World*, 47 Tax L. Rev. 681 (1992).

<sup>92</sup>See Treasury Report, *supra* note 5, at 101-02 (concluding that the AMT has a role to play in an imputation system to ensure that corporations that retain large amounts of preference income pay a minimum amount of tax on retained income).

<sup>93</sup>ALI Reporter's Study, *supra* note 5, at 101-02.

<sup>94</sup>*Id.* at 13-14, 92-93, 102.

<sup>95</sup>*Id.* at 97-98.

the TPA by the amount of the shareholder credit. If the TPA is insufficient to fund the shareholder credit, the corporation must pay an advance corporate tax sufficient to fund the shareholder credit. Advance tax paid by a corporation may be carried forward to offset future corporate tax liability.

The ALI Reporter's Study properly advocates full refundability of the shareholder credit in Proposal 2.a. Failure to allow refundability with respect to low-income individuals would adversely impact on the goal of horizontal equity since the corporate source income of low-income individuals would be subject to a heavier tax burden than other income. It also would decrease vertical equity since high bracket taxpayers could make full use of imputation credits while some low bracket taxpayers could not.<sup>96</sup> Thus, corporate source income distributed to a zero bracket individual taxpayer would escape tax altogether. While such a result may comport with our vertical equity goal, such a result may be objectionable if the zero bracket taxpayer is a tax-exempt entity. Under current law, corporate earnings distributed to tax-exempt entities as dividends are subject to a single corporate-level levy. Thus, allowing credit refundability to tax-exempt entities under imputation would represent a tax

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<sup>96</sup>Id. at 103; McLure, *supra* note 21, at 553-54; see also McLure, Once is Enough, *supra* note 29 at 15-17 (refundability of credit under Carter Commission integration proposal). Cf. Treasury Report, *supra* note 6, at 103 (permitting low-bracket taxpayers to use excess imputation credits to offset tax liability arising from other income but not allowing refund).

decrease from current law. For these reasons, some imputation proposals deny refundability to tax-exempt entities.<sup>97</sup>

The ALI model permits full credit refundability to tax-exempt entities under Proposal 2 but this tax reduction would be neutralized by creating a new explicit tax on the corporate source income of tax-exempt entities under Proposal 9.<sup>98</sup> While the idea that the tax burden on tax-exempt entities "should be uniform and explicitly determined as a matter of tax policy"<sup>99</sup> has clear appeal, its pursuit in the context of an integration proposal is unwise. Tax-exempt entities would vigorously oppose any explicit tax on their corporate source income as the existence of such a tax structure would make them pawns in the annual deficit-cutting games.<sup>100</sup> Their opposition could sound the death knell for integration.<sup>101</sup>

The ALI Reporter's Study notes that the explicit tax under Proposal 9 could be extended to the noncorporate income of tax-exempt entities but it does not make a specific recommendation. The advantage of broader coverage would be to eliminate the incentive for tax-exempt entities to employ individual taxpayers

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<sup>97</sup>See Treasury Report, *supra* note 6, at 103-04.

<sup>98</sup>ALI Reporter's Study, *supra* note 5, at 163-65.

<sup>99</sup>*Id.* at 164.

<sup>100</sup>See Break and Pechman, *supra* note 13, at 99-100.

<sup>101</sup>See Coven, *Corporate Tax Policy for the Twenty-First Century: Integration and Redeeming Social Value*, 50 Wash. & Lee L. Rev. 495 at n. 42 (1993) (suggesting the Treasury Report prefers the dividends received exclusion approach because it places the exempt organizations in the weakest possible position to sustain their tax-preferred status).

as conduits to avoid the explicit tax.<sup>102</sup> Given the extensive stockholdings of tax-exempt entities<sup>103</sup>, a decision to tax corporate but not noncorporate income would encourage tax-exempt entities to redirect their investment toward the noncorporate sector and thus would directly undercut integration's goal of reducing the bias against corporate equity investment.<sup>104</sup> As Professor Warren was willing to endorse an explicit tax on tax-exempt entities, it is hard to understand his reluctance to follow through with a specific recommendation to tax both corporate and noncorporate income.

Under the basic imputation crediting structure with a uniform gross up percentage, all dividends of equal amount carry out the same shareholder credit, whether made out of taxable income or preference income of the corporation or both. When corporate preference income is distributed, a shareholder receives a credit larger than the taxes paid by the corporation with respect to the preference income. This phenomenon is called "superintegration."<sup>105</sup>

There are two logical ways to prevent superintegration. First, the shareholder credit could be harmonized with the amount of corporate taxes actually paid with respect to each

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<sup>102</sup>ALI Reporter's Study, *supra* note 5, at 167.

<sup>103</sup>Treasury Report, *supra* note 6, at 67-68 (pension funds and charities own about 37% of U.S. corporate equity).

<sup>104</sup>ALI Reporter's Study, *supra* note 5, at 167; Halperin, *supra* note 18, at 646.

<sup>105</sup>ALI Reporter's Study, *supra* note 5, at 61-63.

distribution. Alternatively, the corporate taxes paid with respect to each distribution could be harmonized to the amount of a fixed, uniform shareholder credit.<sup>106</sup> The ALI Reporter's Study opts for a uniform shareholder credit because it is much simpler than a system that requires corporations to keep track of the extent to which particular distributions have been made out of preference income.<sup>107</sup> To the extent DWT is levied on distributions out of preference income, the ALI model would result in a heavier tax burden than under the partnership ideal as it would not pass through the benefit of the preferences to shareholders and so taxpayers wanting flow-through treatment in connection with preferred activities would choose a noncorporate form of organization.<sup>108</sup> As compared to current law, the ALI uniform credit approach increases the relative tax burden of tax-exempt shareholders on distributions made out of preference income.<sup>109</sup> Still, the ALI choice is reasonable since the ability to pass preference income to tax-exempt shareholders is not worth inflicting significant complexity on all shareholders.<sup>110</sup>

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<sup>106</sup> *Id.* at 67-90.

<sup>107</sup> *Id.* at 88; Cheney, *supra* note 17, at 1822; AICPA Report, *supra* note 6, at 55-56, 59.

<sup>108</sup> See Treasury Report, *supra* note 6, at 63.

<sup>109</sup> ALI Reporter's Study, *supra* note 5, at 87; AICPA Report, *supra* note 6, at 57.

<sup>110</sup> Compare Treasury Report, *supra* note 6, at 15, 95-101 (choosing a variable credit in structuring its imputation model and then rejecting the model as too complex).

Proposal 3 allows Congress to make an intelligent decision whether to extend the benefit of particular corporate tax preferences to shareholders.<sup>111</sup> Considering the decision to use a fixed credit in the interest of simplicity, Proposal 3 may be viewed as a partial relief measure. The corporation would separately account for those selected items thought to be appropriate for pass-through treatment in an Exempt Income Account (EIA). Distributions would first come out of taxable income until the TPA was exhausted and then out of the EIA.<sup>112</sup>

While Proposal 3 permits a flexible response to the issue of preferred income, artful taxpayers will doubtless attempt to stream EIA distributions to higher bracket taxpayers. The ALI Reporter's Study acknowledges this fact and concedes that Proposal 3 "might" require anti-abuse provisions.<sup>113</sup> While the Internal Revenue Service could arguably address tax-motivated allocations to particular shareholders under authority of IRC §§446(b) and 482, tax policy legislators would be dissatisfied with such *post hoc* corrections and would likely enact a complex battery of anti-streaming provisions. Ironically, the added complexity of anti-streaming provisions may rob the fixed rate credit scheme of much of the simplicity that made it so attractive in the first place. Even so, the uniform credit method is preferable since a variable credit method would require

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<sup>111</sup>ALI Reporter's Study, *supra* note 5, at 108.

<sup>112</sup>*Id.*

<sup>113</sup>*Id.* at 110.

different but equivalent anti-streaming provisions to prevent allocations of unfranked (without an attached credit) dividends to tax-exempt entities.<sup>114</sup>

As discussed *supra*, a disadvantage of shareholder credit integration is that it does not eliminate the corporate bias for debt financing. Proposal 4 is intended to reduce the corporate preference for debt financing by establishing a counterpart Interest Withholding Tax (IWT) to the Dividend Withholding Tax under Proposal 1.<sup>115</sup> Bondholders who receive corporate interest payments would receive a refundable credit that could be used against the bondholder's income tax liability in the same manner as the shareholder credit. While interest would continue to be deductible to the corporation, the corporation's payment of IWT, unlike payment of DWT, would not be creditable against corporate-level income taxes.<sup>116</sup> The ALI Reporter's Study concedes that Proposal 4 is an incomplete solution since tax-exempt entities could use individual taxpayers as financial intermediaries to avoid the IWT bite.<sup>117</sup> Thus, a complete solution to the debt-equity conundrum would require taxing tax-exempt entities on both corporate and noncorporate investment income.<sup>118</sup>

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<sup>114</sup>*Id.* at 106; Treasury Report, *supra* note 6, at 103-04.

<sup>115</sup>ALI Reporter's Study, *supra* note 5, at 112-13.

<sup>116</sup>*Id.*

<sup>117</sup>*Id.* at 113.

<sup>118</sup>Schler, *supra* note 42, at 534.

C. *Extending Integration to Retained Earnings.*

As a distribution-related integration system, basic imputation does not directly relieve the double taxation of retained earnings of the corporation. However, if the corporate tax rate exceeds applicable individual tax rates, imputation may have the effect of reducing corporate retained earnings since lower bracket shareholders can be expected to pressure corporate management to distribute dividends.<sup>119</sup> Pechman notes that encouraging larger dividend payouts by corporations would not be applauded by everyone. Retained earnings of corporations make up a large pool of savings in the United States the reduction of which many would consider unwise.<sup>120</sup>

Proposal 5 of the ALI Reporter's Study allows a corporation with a positive TPA balance that wants to retain its earnings to declare a constructive dividend to its shareholders. The shareholder would receive the normal DWT credit funded by the TPA but instead of receiving cash would increase his or her adjusted basis in the stock. The corporation would keep track of amounts constructively distributed in a separate financial account. Subsequent dividend distributions would be a tax-free return of

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<sup>119</sup>ALI Reporter's Study, *supra* note 5, at 115-116.

<sup>120</sup>Pechman, *Federal Tax Policy*, 187 (5th ed. 1987); see also Sheppard, *Good Times, Bad Times: Business Tax Developments In the Last 20 Years*, 57 Tax Notes 840, 841 (November 12, 1992) (opposition of corporate managers to increased dividends).

capital to the extent made out of this account with shareholders making appropriate basis reductions.<sup>121</sup>

The constructive dividend and reinvestment option would preserve retained earnings as a valuable capital pool while extending the benefits of integration to the constructively reinvested proceeds since the basis increase prevents capital gain taxation of the reinvested proceeds on a subsequent disposition of the stock.<sup>122</sup> The constructive dividend option is not a complete remedy to the retained earnings problem because of two complications. First, the corporate tax rate on non-preference income must be generally conform to the highest individual income tax rate. If the individual rate is higher than the corporate rate, the corporate level taxes paid (i.e., the TPA addition) with respect to a particular constructive dividend would not fully fund the associated DWT credit. Thus, the constructive dividend option depends on a positive TPA balance. Second, even if the corporate and individual rates are equalized, to the extent that a corporation has retained preference income and a zero TPA balance, declaring a constructive dividend would require payment of an advance corporate tax to fund the associated DWT.<sup>123</sup> In effect, corporate managers would be accelerating taxation of the

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<sup>121</sup>*Id.* at 127-28.

<sup>122</sup>ALI Reporter's Study, *supra* note 5, at 125-127; Treasury Report, *supra* note 6, at 87-88.

<sup>123</sup>See *supra* text accompanying notes 95-96, 105-108.

distributed corporate preference income and gaining no benefit except a shareholder basis increase.

In addition to its earnings retention function, the constructive dividend option has one other advantage not mentioned by the ALI Reporter's Study. Because a large TPA balance, like net operating losses, could make a corporation an attractive takeover candidate<sup>124</sup>, declaration of a constructive dividend allows a corporation with a large TPA balance to fend off a hostile suitor by distributing the TPA to shareholders as DWT.

Under Proposal 5, the corporation decides the amount to be constructively distributed to each class of stock in the same manner that it currently sets dividend policy. The ALI Reporter's Study recognizes that anti-abuse provisions might have to be enacted to prevent tax-motivated streaming of constructive dividends to particular shareholders but makes no specific recommendations.<sup>125</sup> Presumably such anti-abuse provisions would require allocation of the constructive distribution among the capital interests of the corporation in a manner akin to the substantial economic effect rules of partnership tax.<sup>126</sup> However, the allocation quagmire in this context involves the

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<sup>124</sup>ALI Reporter's Study, *supra* note 5, at 13, 92-93 (suggesting §382-like limits on the amount of DWT carry forward that would be creditable against future corporate tax liability); Schler, *supra* note 42, at 561-62.

<sup>125</sup>ALI Reporter's Study, *supra* note 5, at 128-29; see also Treasury Report, *supra* note 6, at 87.

<sup>126</sup>IRC §704(b).

same allocation issues that render the partnership method administratively unworkable.<sup>127</sup>

*D. Guaranteeing the Shareholder Level Tax:*

*The ALI Model's Achilles Heel?*

The primary tax liability in any shareholder credit integration model is at the shareholder level. In the ALI model, a single level of tax is achieved by effectively exempting the corporation from taxation except as a withholding mechanism with respect to the shareholder level tax.<sup>128</sup> Thus, the security of the tax base will be subverted if the shareholder can cash out his investment in other than a dividend distribution.

Under the ALI imputation model, corporate income is taxable as ordinary income when finally distributed (actually or constructively) to shareholders. However, if the shareholder sells his stock before the earnings are distributed or receives a liquidating distribution, the shareholder will have converted ordinary income into a capital gain.<sup>129</sup> To illustrate, suppose an individual in the highest tax bracket incorporates a business with nominal capital that then earns \$100 and pays a tax of \$35. If the corporation immediately declares a dividend of the remaining \$65, the shareholder has gross income of \$100 (i.e.,

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<sup>127</sup>See *supra* at text accompanying note 49. Compare Treasury Report, *supra* note 6, at 88 (limiting constructive dividends to holders of common and participating preferred stock).

<sup>128</sup>Schler, *supra* note 42, at 519.

<sup>129</sup>ALI Reporter's Study, *supra* note 5, at 130; Schler, *supra* note 42, at 526-27; Ginsburg, *supra* note 33, at 669.

the \$65 grossed up by the DWT of \$35) and will pay a tax of \$39.60.

Now, instead assume, that the individual liquidates the corporation. The shareholder would have an amount realized of \$100 (the \$65 cash and the refundable TPA of \$35) and a capital gain of \$100. The shareholder will pay the maximum capital gains tax of \$28 and realize a tax savings of \$11.90, or over 29%.<sup>130</sup> Thus, under the ALI model, shareholder capital gains must be taxed at ordinary income rates to ensure the security of the single, immutable shareholder level tax on corporate income.<sup>131</sup>

While extensive use of the constructive dividend and reinvestment option would diminish the threat to the treasury, the efficacy of the constructive dividend option is limited, as explained above.<sup>132</sup> Accordingly, Proposal 6 to the ALI Reporter's Study states that gains on the sale of corporate stock will be taxed at the same rate as that applicable to dividends received by the seller.<sup>133</sup> This requirement does not mean that all shareholders must be taxed in exactly the same fashion. It simply means that the dividend rate and the capital gains rate applicable to a particular shareholder (e.g., tax-exempt entity)

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<sup>130</sup>This example is based on Schler, *supra* note 42, at 526-27. I have modified the illustration for current tax rates.

<sup>131</sup>Yin, *supra* note 31, at 447, 449 ("[E]nactment of a secure single tax on corporate-source income using the approach of the ALI Reporter's Study would be contingent on passage of a series of controversial proposals. Failure to adopt any one of them could cause much of the system to unravel.").

<sup>132</sup>See *infra* text accompanying notes 122-123.

<sup>133</sup>ALI Reporter's Study, *supra* note 5, at 129-30.

must be the same to guarantee that all corporate income is taxed once at the desired uniform rate.<sup>134</sup> Similarly, Proposal 7 attempts to ensure that the promised shareholder level tax is not avoided by use of a redemption or liquidation.<sup>135</sup>

#### E. ALI Imputation Model Results

By eliminating the double taxation of distributed corporate earnings, the ALI imputation model effectively mitigates three of the four major distortions noted *supra* at Section III. First, the elimination of a corporate level tax on distributed income reduces the incentive for individuals to invest in noncorporate assets. Second, the removal of the double tax penalty reduces the incentive for corporations to retain rather than distribute earnings. Finally, corporations do not have to engage in financial legerdemain to achieve a single level of tax; a simple dividend payment does the trick under the ALI imputation model. The ALI model is an incomplete response at best to the fourth major distortion: the debt-equity quagmire. As discussed *supra*, from the shareholder's perspective, reduction of the double tax burden on corporate equity decreases the incentive to invest in debt instruments. However, the corporation will continue to prefer debt financing under the ALI model since corporate managers can experience the immediate thrill of a tax deduction.

While the ALI model reduces most of the major distortions of the classical system, it does not track with the partnership

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<sup>134</sup>Schler, *supra* note 42, at 527.

<sup>135</sup>ALI Reporter's Study, *supra* note 5, at 143-44.

ideal since retained corporate earnings are not taxed at the shareholder's marginal tax rate. Similarly, its failure to pass through preferences (except as specifically enumerated) or losses to shareholders is a significant departure from the ideal partnership norm. In this respect, the ALI model does not make significant changes to current law and thus subchapter S will continue to have appeal for loss corporations.<sup>136</sup>

## VII. Is the Known Devil Is Better Than the Unknown Devil?<sup>137</sup>

The title of the ALI report, "Integration of the Individual and Corporate Income Taxes, Reporter's Study of Corporate Tax Integration," promises the reader an unbiased, balanced examination of integration. The unmistakable message of the 238-page ALI Reporter's Study is that the distortions of the classical system (described in 24 pages) are so unbearable that the only logical action is immediate integration along the lines outlined in its 12 proposals (176 pages). Judging from the treatment accorded them (2 pages), one is left with the distinct impression that the countervailing arguments against integration are unworthy of consideration.

Reflecting in 1992 on first twenty years of *Tax Notes* magazine, Mr. Thomas F. Field, editor and publisher, remarked that for all the seeming frenzied reform activity, there had not

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<sup>136</sup>McNulty, *supra* note 91, at 689.

<sup>137</sup>The phrase as applied to the integration debate is from Bittker and Eustice, *supra* note 76, at ¶1.08.

been any fundamental change in our tax system and noted: "Corporate-personal tax integration remains an idea, not a concrete legislative proposal, despite scholarly discussion, Treasury studies, and a generation-long assault by business groups on the double taxation of corporate income."<sup>138</sup> This observation raises the obvious question: If integration is so clearly a good idea, why are we still grousing about the classical system? The answer, not surprisingly, is that not everyone is convinced that integration is a good idea.

#### A. Quantifying the Benefits of Integration

Before turning to the objections to integration, it may be helpful to attempt to quantify the benefits of integration. We have seen that the classical system results in four major distortions that are generally undesirable. What is the economic cost of these distortions? While the consensus view of the integration literature is that the classical system does result in distortions, until the 1992 Treasury Report, there had been little effort to quantify the economic cost of the classical system.<sup>139</sup>

The Treasury Report predicts first order gains of \$2.5 to \$25 billion annually in U.S. economic welfare depending upon the

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<sup>138</sup>Field, *Taxes and Tax Notes, Then and Now: Two Decades in Review*, 57 Tax Notes 829, 830 (November 12, 1992).

<sup>139</sup>Sunley, *Colloquium on Corporate Integration, Corporate Integration: An Economic Perspective*, 47 Tax L. Rev. 621 (1992); Shuldiner, *Colloquium on Corporate Integration, Commentary, Corporate Integration: Do the Uncertainties Outweigh the Benefits?*, 47 Tax L. Rev. 653 (1992).

chosen integration prototype.<sup>140</sup> While the Treasury Department should be complimented for its effort to quantify the benefits of integration, the economic models used are very rough and the assumptions used to predict behavioral responses to integration are unproven and possibly overstated.<sup>141</sup> Additionally, the predicted gains are based upon full implementation of the chosen integration system. The Treasury Report makes no estimates of the transition costs associated with replacing the classical system.<sup>142</sup> Nevertheless, most economists believe integration will result in significant efficiency gains even if the gains may fall short of those predicted by the Treasury models.<sup>143</sup>

*B. If The Classical System Is So Bad,*

*Why Have We Endured It For So Long?*

Accepting as true that integration will produce significant efficiency gains, why has the U.S. not wholeheartedly embraced abandonment of the classical system? One irony of the integration debate is that the system that comes closest to our ideal corporate tax structure may not be the best system or at least may not be politically possible. In the following

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<sup>140</sup>Treasury Report, *supra* note 6, at 111; cited favorably by ALI Reporter's Study, *supra* note 5, at 43.

<sup>141</sup>Shuldiner, *supra* note 139 at 655; Cummings, 'Taxing Business Income Once': Where's the Beef? A Review and Critique of the Treasury Study, 54 Tax Notes 1391, 1393, 1394 (1992).

<sup>142</sup>Shuldiner, *supra* note 139 at 654.

<sup>143</sup>*Id.* at 655. Contra Pechman, *supra* note 120, at 188 ("There is no evidence ... that the corporation tax has impaired the growth of the corporate sector or of the U.S. economy as a whole.")

paragraphs, I list some reasons integration is still just an idea and not a concrete legislative proposal. My intention in listing the countervailing arguments is not to pass judgment on their truth or substantiality, but simply to show that the case for integration is not as clear cut as the ALI Reporter's Study would lead one to believe.

### 1. The Need for Integration

The corporate level tax may be viewed as a second-best solution to the undertaxation of undistributed corporate income.<sup>144</sup> Double taxation dates from Revenue Act of 1936 but for fifty years double taxation was effectively neutralized by several structural features of the tax system: high individual tax rates, lower corporate tax rates, and preferential treatment of capital gains. While the classical system's double taxation of distributed corporate earnings did impose a heavier burden on corporate investment, to the extent that the taxpayer made long-term investments in corporations that retained earnings, the burden of double taxation was obviated. After the Tax Reform Act of 1986, however, it became much more difficult for taxpayers to neutralize the effects of double taxation. Congress increased the relative tax burden on corporate source income to almost twice the burden imposed on other income by (1) setting the maximum corporate rate above maximum individual rate (so that even low income taxpayers were hurt); (2) decreasing the benefit

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<sup>144</sup>Kwall, *The Uncertain Case Against Double Taxation of Corporate Income*, 68 N. Carolina Law Review 613, 629-31 (1990).

of deferral since corporations had to pay higher tax on retained earnings; and (3) repealing the 50% capital gains deduction.<sup>145</sup> The 1993 Omnibus Budget Reform and Reconciliation Act reversed the rate inversion that pertained from 1986 to 1993 by again raising the highest individual rate to 39.6% as compared to a maximum corporate rate of 35%. Thus, higher income taxpayers can again find tax savings through corporate sector investment.

Some commentators have pointed out that the double tax burden is not as burdensome as it might appear since there is a great deal of integration under current law, some of it official and some of it of the self-help variety.<sup>146</sup>

## 2. Revenue Concerns

Integration would result in a significant loss of revenue. For example, the Treasury Report estimates a revenue cost of \$14.6 billion for its shareholder credit prototype that lacked credit refundability and denied the benefits of integration to foreign and tax-exempt shareholders. The Treasury Report estimated that other methods could cost as much as \$50 billion or more.<sup>147</sup>

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<sup>145</sup>Id. at 618-625 ("For the first time in history, therefore, the double taxation of corporate income often causes such income to bear a tax burden substantially greater than the single tax imposed on income from other sources.").

<sup>146</sup>Johnson, *Corporate Integration Discussed at American Law Institute Conference, Tax Notes Today* (January 9, 1992) (reporting remarks of Professor James Eustice at Association of American Law Schools (AALS) meeting in San Antonio, Texas); Bittker and Eustice, *supra* note 76, at ¶1.08(c).

<sup>147</sup>Treasury Report, *supra* note 6, at 152.

Some commentators argue that the effects of raising other taxes to replace the revenue lost because of integration may be more objectionable than the effects of double taxation.<sup>148</sup>

### 3. Vertical Equity

Because individual shareholders tend to be upper income taxpayers, double taxation falls heavier on them and may increase progressivity of the income tax in the aggregate.<sup>149</sup> While the aggregate result of the incidence of the corporate tax may further vertical equity, integrationists criticize it as an exceptionally blunt instrument for achieving progressivity.<sup>150</sup> Other commentators believe that the full burden of the corporate tax does not fall on shareholders but rather is shifted largely to consumers. To the extent the burden is shifted forward to consumers, the corporate tax is a crude sales tax that like all general sales taxes is regressive in its effects.<sup>151</sup> Even if the corporate tax is indirectly regressive, the public perception of

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<sup>148</sup>Kwall, *supra* note 144, at 616-17, 627 (higher individual rates needed to maintain progressivity would increase pressure on Congress for additional preferences and thus derail recent reform movement to a low rate, broad-based income tax system); Johnson, *supra* note 146; Treasury Report, *supra* note 6, at 14 ("Replacement taxes may create distortions and alter the distribution of tax burdens."); Cummings, *supra* note 141, at 1393-94 (1992).

<sup>149</sup>Pechman, Who Paid the Taxes, 1966-1985?, 80 (1985); Break and Pechman, *supra* note 13, at 94; Kwall, *supra* note 144, at 616-17.

<sup>150</sup>McLure, Once is Enough, *supra* note 29, at 3; McLure, *supra* note 21, at 535-36; Harriss, *Taxation of Business: Fundamental Issues, Essays on Taxation* at 39, 44 (1974); AICPA Report, *supra* note 6, at 17; Feldstein and Frisch, *supra* note 59, at 17.

<sup>151</sup>4 Report of the Royal Commission on Taxation (Canada) (1966) at 3-9, 19-28, excerpted in Sander and Westfall, *Readings in Federal Taxation*, 449 (1970); Fullerton and Rogers, Who Bears the Lifetime Tax Burden?, at 180-84, 225-28 (Brookings, 1993).

the elimination of the corporate level tax is that it is a tax break for corporations and the rich.<sup>152</sup>

#### 4. Corporate Opposition

While it might seem that corporations would be a natural constituency for integration, not all corporations would be benefitted by distribution-related integration as either a dividend deduction or shareholder credit system would benefit corporations that pay out large portions of their earnings.<sup>153</sup> Various tax preferences, many enacted as partial relief for the double tax burden, benefit corporations in different degrees and mean that effective rate of tax for corporations varies widely.<sup>154</sup> If integration were financed by repeal of beneficial tax preferences, businesses benefitting the most from preferences would oppose integration as it would result in a major shift in the relative tax burdens of dividend-paying corporations versus growth corporations and noncorporate business entities.<sup>155</sup>

Corporate managers also fear that shareholders will push for dividends and the corporation will end up without funds for

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<sup>152</sup>Sheppard, *supra* note 22, at 646.

<sup>153</sup>Cheney, *supra* note 17, at 1821; New York State Bar Association, The Committee on Corporations of the Tax Section, *Report on the Integration of Corporate and Individual Income Taxes*, 31 Tax Lawyer 37, 41, 63 (1977); AICPA Report, *supra* note 6, at 8, 9.

<sup>154</sup>Break and Pechman, *supra* note 13, at 91.

<sup>155</sup>New York State Bar Association, *supra* note 153 at 41, 63; McLure, *Where Tax Reform Went Astray*, 31 Vill. L. Rev. 1619, 1657 (1986) (50% dividend paid deduction proposal in Treasury I torpedoed by lukewarm support from business community who would have traded integration for retention of ACRS and investment tax credit).

investment.<sup>156</sup> While some commentators are unsympathetic<sup>157</sup>, others fear that the already deplorable U.S. savings rate will be further degraded.<sup>158</sup>

Multinational corporations also may oppose integration since it may upset the existing neutrality between foreign and domestic investment.<sup>159</sup>

##### 5. State Tax Administrator Opposition

The Treasury Report has been criticized by New York State Taxation and Finance Commissioner James Wetzler for not addressing the effects of integration on state tax administration.<sup>160</sup> Such criticism would be equally well directed to the ALI Reporter's Study.

Besides issues of complexity for federal tax purposes, integration raises many state tax administration issues including:

- will the States conform their corporate and individual income taxes to the federal model of integration?

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<sup>156</sup>Cheney, *supra* note 17, at 1821; Johnson, *supra* note 146; AICPA Report, *supra* note 6, at 8.

<sup>157</sup>Sheppard, *supra* note 12, at 841 (corporate managers oppose integration because they like to "act as investment managers for the shareholders, and the two-tier tax has always provided a convenient excuse").

<sup>158</sup>Pechman, *supra* note 120, at 187.

<sup>159</sup>New York State Bar Association, *supra* note 153 at 63; Tillinghast, *supra* note 75, at 1215; Wrappe, *supra* note 75 at 727.

<sup>160</sup>BNA Daily Tax Report, *Surge in Limited Liability Company Laws Seen Driving Move to Corporate Integration* (May 26, 1993); Hubbard, *New York Tax Commissioner Questions Cost of LLCs, Integration*, 59 Tax Notes 1143 (May 31, 1993).

- what effect will failure to conform have on success of integration at the federal level?
- if states followed the federal lead in adopting integration, what effect would this have on revenue distribution (since corporations do not necessarily do business or pay state income taxes in the same states where their shareholders reside)?<sup>161</sup>

#### *6. Populism and Politics*

Politicians fear backlash from voters' perception that integration seems to give advantages to powerful corporations and rich individuals.<sup>162</sup> If anything, Congress appears unmoved by the pleas of integrationists and has frequently acted to bolster the two-tier corporate tax by controlling do-it-yourself integration schemes.<sup>163</sup>

<sup>161</sup>New York State Bar Association, *supra* note 153, at 62-63 (net loser States will be reluctant to follow the federal lead and "[a]ny material departure from the federal system would result in undesirable complexity, and might also counteract to some degree the anticipated effects of the federal integration of shareholder and corporate income taxes"); see also Hubbard, *supra* note 160, at 1143; AICPA Report, *supra* note 6, at 29-30.

<sup>162</sup>ALI Reporter's Study, *supra* note 5, at 56; Cheney, *supra* note 17, at 1822; Hubbard, *supra* note 160, at 1143 (quoting James W. Wetzel, New York Commissioner of Taxation and Finance); Kirchheimer, *Nunn and Domenici Want To Replace Tax System To Encourage Savings*, 61 Tax Notes 143, 145 (October 11, 1993) (Danforth cautioned Nunn and Domenici that their consumption tax plan with an integrated corporate tax would have to sold to taxpayers -- "Please don't underestimate the juice that distribution tables have. That's where the debate is going to be."); Lee, *The Corporate Income Tax - Who Really Pays*, Forbes, August 13, 1984 at 32(3). See also Epstein, *Reagan's Offhand Tax Remark Was Just That*, Philadelphia Inquirer, Page A-1 (January 28, 1983) (President Reagan describing corporate tax as "hard to justify"; damage control effort by Reagan aides denying abolition of corporate tax as a public policy goal since it would reinforce perception that Reagan's policies were unfair to the poor).

<sup>163</sup>Sheppard, *supra* note 12, at 841 (citing repeal of General Utilities doctrine and crackdown on publicly-traded partnerships); *Use of Limited Liability Companies Seen Not Jeopardizing Corporate Tax Base*, Daily Tax Report (BNA), March 30, 1993 (House Ways and Means Committee Hearings on limited

The view that corporations are separate legal entities that benefit from incorporation and therefore are suitable subjects for taxation apart from individuals still has its adherents on Capitol Hill.<sup>164</sup>

Even if Congress is interested in integration, the tax provisions will be multi-sectional, extremely complicated, and involve almost every issue of corporate taxation. At least one commentator doubts that Congress can produce coherent legislation to implement integration.<sup>165</sup>

If Congress were interested in integration, it seems unlikely that the ALI imputation model would be the chosen integration system. The ALI system imposes significant new tax liability on shareholders (and on some debtholders) that are currently tax-exempt. While imputation credits would mitigate the effect of current dividend taxation, credits will not be available to offset tax liability arising from sales of appreciated stock, and so opposition to the repeal of preferential capital gains treatment can be expected. As explained above, failure to tax capital gains from stock dispositions at the same rate as dividends would threaten the security of the tax base and cause the fabric of the ALI

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liability companies as self-help integration).

<sup>164</sup>Sheppard, *Corporate Integration: Always Interesting and Often Irrelevant*, 58 Tax Notes 1415 (March 15, 1993) (reporting remarks of Peter Cobb, business tax counsel of the Joint Committee on Taxation who questioned the need for dividend relief since corporate tax is in effect a tax on access to public securities markets).

<sup>165</sup>Johnson, *supra* note 146.

imputation model to unravel.<sup>166</sup> On the other hand, an integration system based on a dividend paid deduction or dividend received exclusion mechanism is politically more palatable since they merely give taxpayers better dividend tax treatment and do not impose any new taxes on anyone.<sup>167</sup>

*C. The Classical System Is a Morass But It Is Our Morass*

Most opponents of integration would doubtless agree with the ALI Reporter's Study that the classical system is a hopelessly complicated maze. However, unlike the ALI Study, the separatists are not ready to junk the maze. They reason that even if we cannot find our way out of the maze at least we know our way around it. Yes, it is a morass but it is a morass we know. We should be hesitant to replace it with a morass we do not know.<sup>168</sup>

**VIII. Conclusion**

While the ALI Reporter's Study is a valuable addition to the integration literature, its value lies in its detailed examination of the mechanics of the shareholder credit integration system. Unfortunately, the ALI Reporter's Study makes no serious effort to prove that the distortions of the classical system are so detrimental as to warrant "throwing chaos

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<sup>166</sup>See *supra* text accompanying notes 128-135.

<sup>167</sup>Schler, *supra* note 42, at 520.

<sup>168</sup>Cummings, *supra* note 141 at 1395; see also Yin, *supra* note 31, at 445 ("The ALI Reporter's proposal would not be a simple system of integration to implement.").

. . . to the winds."<sup>169</sup> There are enough uncertainties in the integration debate to conclude that Professor Warren will find the classical system wheezing and sputtering along should he choose to return again to the fray in twelve years time.<sup>170</sup>

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<sup>169</sup>Ginsburg, *supra* note 33, at 666 (quoting Justice Roger Traynor, Comment on Courts and Lawmaking, in *Legal Institutions Today and Tomorrow* at 56 (Monrad Paulsen ed., 1959)).

<sup>170</sup>See Sheppard, *supra* note 164, at 1415 (reporting remarks of Peter Cobb, business tax counsel of the Joint Committee on Taxation to effect that integration has no natural political constituency and is really only seriously considered in conjunction with enactment of a consumption tax).

**PROPOSALS OF THE ALI REPORTER'S STUDY**

1. Dividend Withholding Tax. pp. 13, 92-93.

a. A dividend withholding tax (DWT) will be imposed on distributing corporations with respect to qualified dividends. The DWT rate will equal the highest individual tax rate in the year of distribution[, which will also be the standard corporate rate].

b. Qualified dividends will be distributions of money or property to shareholders as declared dividends or deemed to be dividends by the Code, without regard to whether there are current or accumulated corporate earnings and profits.

c. Each subchapter C corporation will maintain a taxes paid account (TPA) with an initial balance of zero. The balance in the TPA will be increased by the amount of U.S. corporate income taxes, including minimum taxes, paid by the corporation, and reduced by any corporate tax refunds received by the corporation. Refunds in excess of a TPA balance will be immediately due as DWT. Legislative adjustments to TPA balances may be made in the case of major changes in tax rates.

d. The distributing corporation's liability for DWT will be satisfied by any amount in the corporations' TPA. Use of a TPA balance to satisfy DWT liability will result in a corresponding reduction in the TPA. Amounts paid to the U.S. Treasury as DWT will be creditable against future corporate tax liability. This carryforward of DWT will be subject to

limitations similar to those in section 382 in the event of a change in corporate ownership.

2. Shareholder Withholding Credit. pp. 13-14, 102.

a. On receipt of a qualified dividend, a shareholder who is a noncorporate U. S. citizen or resident will include the dividend (including the DWT) in gross income. The associated DWT will be creditable against shareholder income tax liability, with any excess refundable.

b. Pass-through entities, such as partnerships, will pass through the dividend income and withholding credit in accordance with the provisions applicable to such entities.

3. Certain Tax Preferences. pp. 14-15, p. 108.

a. Corporations will maintain an exempt income account (EIA) to which will be added the qualified exempt income received by the corporation, and from which will be subtracted distributions of such income by the corporation to its shareholders as qualified dividends.

b. Distributions of qualified dividends when there is a zero balance in the TPA, but a positive balance in the EIA, will give rise to neither DWT nor shareholder taxable income. Instead, the dividend will be nontaxable to the shareholders to the extent of the balance in the EIA. Corporations will notify shareholders of the amounts to be excluded from income a exempt dividends.

c. "Qualified exempt income" will be the following specified categories of income received by corporations: [interest excluded by section 103...]

d. Qualified tax credits will be treated as corporate taxes paid for purposes of computing the balance in the TPA. "Qualified tax credits" will be the following specified categories of tax credits received by corporations: [...]

e. The balance in the TPA will be reduced by the product of the corporate tax rate and the following disallowed deductions: [...]

4. Interest Withholding Tax. pp. 15, 112.

An interest withholding tax (IWT) will be levied on corporate payments of interest on other than trade credit at the same rate as the DWT. The credit for taxes withheld will be usable against U.S. tax liability and refundable to the same extend as the shareholder withholding credit.

5. Constructive Dividends. pp. 15, 126-127.

a. In lieu of a qualified dividend of money or property, a corporation may declare a constructive dividend to its shareholders, followed by a constructive capital contribution of the proceeds. Such a constructive dividend and reinvestment will give rise to the same tax consequences as an actual qualified dividend, followed by reinvestment of the after-tax proceeds in stock of the distributing corporation. The distributing corporation will notify its shareholders of the

amount to be included in income, the associated DWT, and the resulting increase in basis.

b. Amounts constructively distributed and reinvested will be recorded by the corporation in a previously taxed dividends account. If the balance in the TPA is zero, qualified dividends to shareholders will be considered as offsets to shareholder basis to the extent of previously taxed dividends. Qualified dividends in excess of such basis will be taxable income to the shareholders.

6. Disposition of Stock. pp. 16, 129-130.

a. Gains on the sale of corporate stock will be subject to taxation at the rates that are applicable to dividends and other ordinary income received by the seller.

b. Losses on the sale of corporate stock will be deductible to the extend of: (a) dividends and realized gains on the sale of corporate stock, and (b) the excess of such losses over net unrealized gains on shares of corporate stock. Disallowed losses will be carried forward indefinitely.

c. An increase in share basis under section 1014 will be reduced by the allocable portion of the TPA balance divided by the corporate tax rate.

7. Nondividend Distributions. pp. 16-17, 143-144.

a. In the case of a redemption of stock that is subject to section 302(d), the distributing corporation and the receiving shareholder will treat the amount paid for the shares as a qualified dividend for purposes of computing the DWT and

shareholder withholding credit. In the case of a redemption directly from a shareholder that is taxed as an exchange by the shareholder under section 302(a), the corporation will reduce its TPA by the product of the TPA balance and the ratio of the fair market value of shares redeemed to the fair market value of total shares outstanding before redemption. Redeeming shareholders will be notified of the per share reduction in TPA, which amount will be included in the redeeming shareholders' amount realized and creditable as DWT.

b. A corporation that purchases its own shares on a stock market in a transaction to which (a) does not apply will be entitled to a refund of the portion of its TPA balance allocable to the repurchased shares.

c. If more than eighty percent of the stock of a corporation is acquired from noncorporate shareholders by another corporation in a taxable transaction, the acquired corporation shall be entitled to a refund of its TPA balance allocable to the purchased shares.

d. On complete liquidation of a corporation subject to taxation under section 331, the remaining balance in the TPA will be available pro rata as a shareholder withholding tax credit for shareholders receiving liquidating payments. The amount of this credit will be included in the amount realized by the receiving shareholders. On complete liquidation of a subsidiary subject to nonrecognition under section 332, the

receiving corporation will increase its TPA balance by its share of the liquidating corporation's TPA balance.

8. Corporate Investors. pp. 17-18, 154-155.

a. In the absence of an election, a shareholder that is a U.S. corporation will include qualified dividends in gross income, and credit the DWT against the resulting tax liability, which, in turn, will increase its TPA.

b. In the case of a shareholder that is a U.S. corporation and owns more than twenty percent of the stock of the distributing corporation, the distributing corporation may elect to treat the dividend as nontaxable and noncreditable to the recipient corporation. If such an election is made, the TPA of the distributing corporation will not be reduced as a result of the distribution, nor will DWT be payable with respect to the dividend, nor will the TPA of the receiving corporation be increased as a result of the dividend, nor will the receiving corporation include the dividend in gross income. The election will be available only when the distributing corporation's TPA balance is zero.

c. Dividends between affiliated corporations filing consolidated returns will continue to be nontaxable, and a parent corporation's basis in subsidiary stock will continue to be adjusted for earnings of the subsidiary in accordance with the consolidated return regulations. The TPA and DWT carryforward of an affiliated group will be computed on a consolidated basis.

9. Exempt Investors. pp. 18, 163-164.

A new tax will be levied on the investment income of exempt U.S. investors in corporate capital interests. DWT and IWT will be fully creditable against this tax, and any excess will be refundable. The tax base will include dividends and interest received from U.S. corporations, and gains on the sale of stock and debt in such corporations [as well as other investment income]. The rate of this tax could be set at different levels for different categories of exempt entities, such as charities and pension funds.

10. Foreign Investors. pp. 19, 190-191.

a. A new foreign investor's tax (FIT) will be levied on U.S. investment income of foreign investors. DWT will be creditable by foreign investors against this tax, and any excess will be refundable. The statutory rate of FIT should equal the rate of DWT. The FIT will replace the current withholding tax on foreign investors and will be subject to mutual reduction in tax treaties. The tax base will include interest and dividends paid by U.S. corporations and gains realized on the sale of stock or debt or debt of U.S. corporations [as well as other investment income].

b. Stock in a U.S. corporation previously held by a foreign shareholder will not be eligible for shareholder credits for a period of ten years in the absence of certification that previous foreign shareholders have paid FIT on their gains.

11. Foreign Income. pp. 19, 198.

A U.S. corporation with foreign income will add to the exempt income account described in Proposal 3(a) an amount equal to its taxable foreign source income, reduced by the associated creditable foreign taxes. That addition will be limited to the foreign taxes multiplied by  $(1-c)/c$ , where  $c$  is the U.S. corporate tax rate. The foregoing treatment will be available only as part of a tax treaty.

12. Percentage of Integration. pp. 19-20, 209-210.

Transition to full conversion of the income tax into a withholding tax could be accomplished by increasing the "percentage of integration" from some initial amount over time to 100. At any given moment, the percentage of integration would indicate the extent to which the additional burden of the corporate tax had been eliminated by integration.

a. The following amounts will be multiplied by the percentage of integration: (i) corporate taxes paid (before addition to the TPA); (ii) corporate tax refunds (before subtraction from the TPA; and (iii) foreign income net of foreign taxes (before addition to the EIA).

b. The rate of DWT will be  $ic/(1-c+ic)$ , where  $i$  is the percentage of integration and  $c$  is the corporate tax rate.

c. The intercorporate dividends received deduction will apply to a taxable dividend (including the DWT) multiplied by  $[(1-c)(1-i)]/(1-c+ic)$ . If the election provided for in Proposal 8(b) is in effect, the amount included in taxable

income by the receiving corporation will be determined by multiplying the dividend times  $(1-i)(1-d)$  where  $d$  is the applicable percentage of the dividends received deduction under section 243.